FOR FINANCIAL PROFESSIONALS ONLY

Small-Cap Market Review

1Q17

Interview

Portfolio Manager Chuck Royce and Co-CIO Francis Gannon look at the performance reversals and cross-currents in 1Q17, the likelihood of higher volatility, and why lower returns for small-caps might be the pause that refreshes.

Chart Book

A comprehensive overview of our asset class including long-term market cycles and performance patterns, style, and active vs. passive.

Fund Performance and Commentary

A look at how Royce's featured U.S. value and core strategies have fared.

Royce&Associates

Royce&Associates

Small-cap specialist with unparalleled knowledge and experience, offering distinct investment approaches to meet a variety of investors' goals.

Unparalleled Knowledge + Experience
Pioneers in small-cap investing, with 40+ years of experience, depth of knowledge, and focus.

Independent Thinking
The confidence to go against consensus, the insight to uncover opportunities others might miss, and the tenacity to stay the course through market cycles.

Specialized Approaches
Strategies that use value, core, or growth investment approaches to select micro-cap, small-cap, and mid-cap companies.

Unwavering Commitment
Our team of 16 portfolio managers have significant personal investments in the strategies they manage.

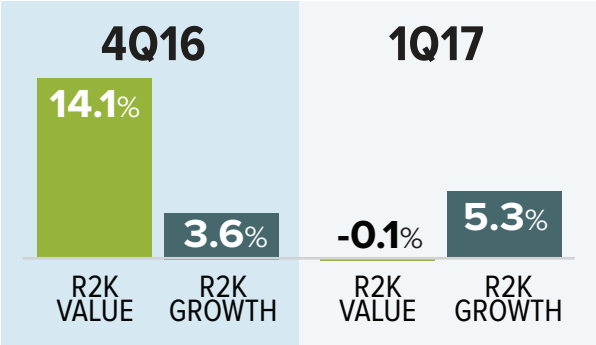
1Q17 Interview

Portfolio Manager Chuck Royce and Co-CIO Francis Gannon look at the performance reversals and cross-currents in 1Q17, the likelihood of higher volatility, and why lower returns for small-caps might be the pause that refreshes.

What was your take on 1Q17?

Chuck Royce I think what was most interesting in 1Q17 were the short-term reversals of what worked in 2016, especially in the fourth quarter. In the first quarter, we saw reversals in leadership based on market capitalization, style, and sector. Large-caps beat small-caps, growth beat value, and healthcare stocks overcame a weak 2016 while Energy—one of the stronger areas for small-cap in 2016—fell farthest. So a lot of what worked best in 2016, especially late in 2016, did not work in 1Q17—and vice versa.

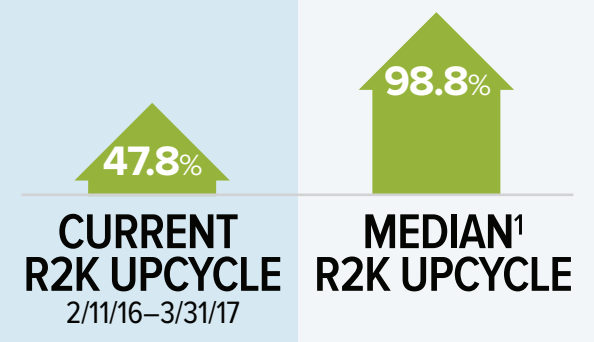
Francis Gannon The higher returns for growth seemed to us in many ways like a validation of the high returns small-cap value stocks posted in 2016, even allowing for the fact that overall valuations were somewhat high as we entered April based on more realistic expectations. In other words, if those returns didn't feel in some sense well-earned to investors, we probably would have seen a bigger pullback for value in addition to the catch-up for growth. That it played out the way it did, with a strong return for growth with value down just slightly, suggests to us that equities remain in basically good shape.



After the Russell 2000 Index hit a new high on 3/1/17, what leads you to believe that small-caps still have room to run?

CR I think context is critical when thinking about the longevity of the current small-cap cycle. First, the bull market in large-cap stocks is aged. It just hit its eight-year anniversary, dating back to 3/9/09, which was the market trough following the Financial Crisis. Small-caps bottomed on that same day, too, but the Russell 2000 Index has since had two subsequent bear markets–the first ended on 10/3/11 and the second on 2/11/16. So the current small-cap cycle, which is a little more than a year old, is quite young, especially compared to large-cap's.

FG It's also important to keep in mind just how resilient the current rally has been, which we find very encouraging. In less than a year, the markets have been rocked by Brexit, the highly contentious election, and the false start on healthcare reform. Yet none of these events have done more than temporarily slow the overall upward move for small-caps.



Closely related to this is the median return for the Russell 2000 following declines of 15% or more. There have been 11 since the Russell 2000's inception in 1979. The median return in the subsequent recovery was 98.8%. The last small-cap bear market, which Chuck mentioned, was a 25.7% drop from 6/23/15-2/11/16, and from that February 2016 bottom through the end of 1Q17, the Russell 2000 was up 47.8%. So history suggests we are less than halfway through, which means the cycle is young not just in terms of time—and in our view has room to run.

Do you think small-caps could still experience a modest correction?

CR Yes. We don't expect a significant decline or bear market for small-caps. Our estimate is somewhere in the 5-12% range. Many investors seem concerned that the timeline for new stimulative fiscal policies may extend into 2018, tempering the postelection optimism that animated 4Q16's market. In fact, at the end of 1Q17, much of the market looked high priced enough to us and many others that the next downdraft will be one of the most highly anticipated in many years.

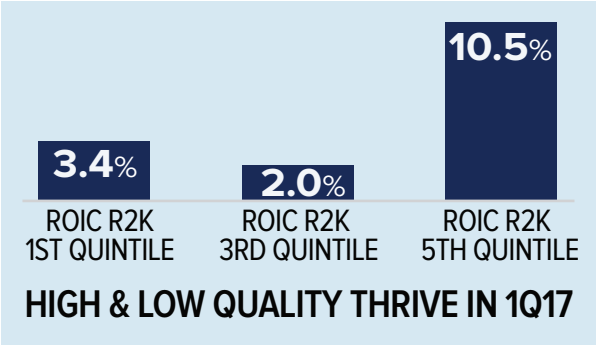
All of this sounds more to us like a pause in a longer bull phase than a scenario for a bear market. Instead of a broad-based pullback, we think additional rolling sector- and industry-based corrections are more likely in the months ahead, similar to what we saw for industrial stocks in 2015, healthcare in 2016, and energy so far in 2017.

FG As bottom-up small-cap specialists, we're not as concerned as some investors are with developments in Washington, whether at the Fed or on Capitol Hill. Our focus is on our analysis of, and communication with, individual companies, so we see the rally as having a more substantial foundation.

This is why we think upcoming earnings announcements—and guidance—will play a big role in the market's moves, which is what we would want and expect in the current climate. Psychology runs the market in the short run, but earnings run it in the long run. And this small-cap market seems to be going through a correction in time, where future earnings need to catch up to current prices.

Were you surprised that both high-quality and low-quality small-caps did well in 1Q17?

CR Not entirely, although it was such a strong quarter for growth that it may seem a little counterintuitive that quality did so well. However, quality companies, which we measure by high returns on invested capital (ROIC), were substantially disadvantaged, and therefore deeply discounted, by expansive monetary policy and zero interest rates from 2011-2015. So even after last year's strong run, other investors are continuing to show interest in a number of high-quality small-caps.



FG It's also helped that, as monetary policy moves off center stage, more attention is being paid to fundamentals such as earnings, profitability, and the ability to self-finance. This clearly helped many high-quality small-caps in 2016 and in 1Q17.

As for lower quality, I think it had to do with the ongoing success of many tech companies, which received little attention, as well as the catch-up dynamic we mentioned earlier. There's also the possibility for additional economic acceleration.

Can you expand on the performance patterns you saw in 1Q17 ?

CR In our small-cap market, we noticed how narrow returns for the asset class were in 1Q17, which is often the case when growth leads. The cap-weighted Russell 2000 was up 2.5% while the equal-weighted index was up only 0.1% in 1Q17. This suggests that the market was weaker than it appeared, which is borne out by the fact that healthcare's leadership was itself confined primarily to the sector's biotechnology, pharmaceutical, and healthcare technology areas. We certainly did not see a broad-based move for growth as a whole in 1Q17.

[1] Median includes only full recovery periods of the Russell 2000 after a decline of 15% or greater since the index's inception (12/31/1978)

So it looked a lot to us like 3Q16 in that much of what worked best in 2016 as a whole—dividends and low leverage, for example—trailed in both periods. In fact, 1Q17 looked to us like a consolidating market, with laggards such as the Nasdaq, large-caps, and growth all catching up, which was the opposite of what happened in 2016. Still, we see the cycle as a very healthy one, even with its 'two steps forward, one step back' pattern.

Why do you think small-caps are likely to see more volatility in the months ahead?

FG The low volatility in the markets over the last few months feels like an eerie stillness, almost like the calm before the storm, especially with valuations high. Coupled with the political volatility we've seen, the low volatility environment doesn't seem sustainable. Markets simply do not stay steady, predictable, and/or placid for extended periods. Something has to give at some point—and with stock prices running high, it seems to us that higher volatility is likely.

How are you approaching portfolio positioning in a period of high valuations?

CR With buying opportunities being pretty limited, we've been looking at discrete buys across disparate industries. Some have been special situations while others are companies undergoing transitions that have created what we think are attractive valuations. Another area are firms with complex business models where we think the complexity makes it hard for most investors to gauge the profit potential. More generally, we're staying prepared for any pullback, whether in particular sectors or in small-cap as a whole, so that we can move quickly when opportunities arise.

We're also looking closely at some of our largest positions and have trimmed some of our top contributors from 2016 so that they do not become too large a percentage of a given portfolio's net assets. We want to preserve portfolio diversity, which is an important risk management tool that assumes greater importance when share prices have been rising over an extended period.

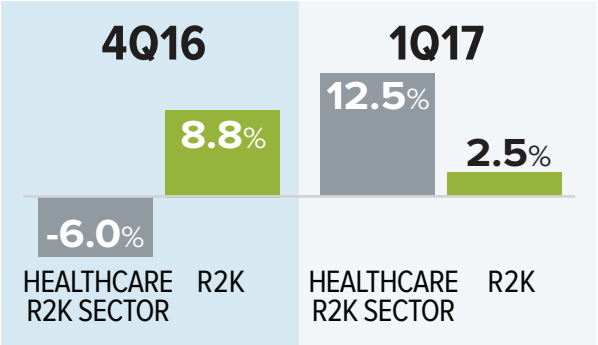
With Health Care's rebound in 1Q17, how have you been approaching that sector?

CR The long-term opportunities throughout the sector are very real, but we need to carefully balance valuation with company quality. In general, that's easier to do outside the more speculative bio-pharma complex, but there are still risks, especially with reforms to the Affordable Care Act still not settled. Pricing remains an open question in many cases.

In addition, valuations through much of the sector still looked a bit high to us at the end of March. I've slightly increased my exposure in some portfolios, mostly by adding to positions that are solid earners with the potential to stay that way. It's a sector that we'll be watching closely over the next several months, especially considering that volatility has been more prevalent in healthcare stocks over the last 15 months. If that continues, we should see additional opportunities to buy at prices that look attractive to us.

Are the management teams you've met with recently feeling more confident about economic growth?

CR We have definitely heard a tonal shift to greater optimism from many management teams since the election. As we've observed, there was a lot of data that showed the economy was improving prior to November that had been bottled up. The good news is that even as the new Administration and Congress have hit some road bumps in terms of implementing policy, the managements are maintaining their positive perspective, even after allowing for the fact that optimism has run a little ahead of reality.



Based on what you've been hearing, what is your outlook for Capex spending?

FG We're cautiously bullish. It's true that many businesses have a very real need to reinvest, particularly in technology, and have had that need for several years. Economic conditions are finally improving to the point where a robust round of spending looks feasible. The PMI is up, the job market continues to improve, and wages are rising. So the outlook is promising. What complicates this rosy picture is the possibility that earnings improvement doesn't materialize to the degree necessary to sustain expectations. That's the air pocket—that's the distance between optimism and reality that might lead to higher levels of volatility.

What do you make of the Fed's decision to raise rates on March 15th?

FG It was a positive sign, not just for the hike itself but also for the likelihood of two further increases later in the year. These represent votes of confidence in a growing economy. To be sure, what might be most interesting is that when news came out earlier in March that there would likely be three rate hikes in 2017, not only was there no 'taper tantrum,' but the market basically shrugged.

The Fed's role in the economy—and in the perception of how well the economy is doing—has been diminishing, which itself is a positive sign. It shows that the condition of companies and the potential for effective fiscal policies are now more important than monetary policy. Moreover, we would encourage anyone concerned about the effects of rising interest rates on small-cap stocks to watch a recent video we made in which we look at data showing that small-caps actually have lower interest rate sensitivity than large-caps.

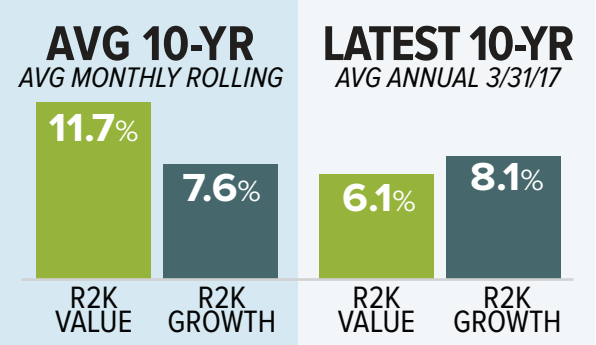
Do you expect small-cap value to maintain leadership in the current cycle?

CR Yes, we do. We expect the shift in leadership to value, which began with the June 2015 small-cap peak, to be a lasting one. It marked a genuine regime change in small-cap leadership that was accompanied in 2016 by improved results for small-caps versus large-caps and cyclical stocks.

We see no rotations in long-term sector or style leadership and expect that the three reversals from 2016 that we've been emphasizing—positive long-term returns for small-cap, value leading growth, and cyclicals beating defensives—will remain in place. As far as value's leadership is concerned, it's worth noting that at the end of the quarter the Russell 2000 Value was still 200 basis points behind the Russell 2000 Growth on an annualized 10-year basis despite having a historical advantage of 410 basis points over all 10-year monthly rolling periods.

FG We expect that the small cap market will resume its advance later this year. The basically flat market from the 2016 high on 12/9 through 3/31/17, in which the Russell 2000 was up 0.3%, may have been the small-cap pause that refreshes. After all, the economic news remains positive here in the U.S. and is improving globally, and it shouldn't take much acceleration to help stocks. The small-cap earnings outlook remains decent to bright, depending on the industry, as do the prospects for margin expansion. The dollar corrected slightly in 1Q17, which is a good sign for many small-cap companies and, while rates are rising, yields have so far not elevated too quickly or too high.

Value stocks have also historically outpaced growth issues when the economy is expanding while also showing less sensitivity to rising rates than their growth counterparts. So while we're not expecting returns to move in a straight line up, we think it's likely that small-caps have room to run.



Important Disclosure Information

Mr. Royce's and Mr. Gannon's thoughts and opinions concerning the stock market are solely their own and, of course, there can be no assurance with regard to future market movements. No assurance can be given that the past performance trends as outlined above will continue in the future.

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1Q17 Chart Book

As small-cap specialists, we offer a comprehensive overview of our asset class including long-term market cycles and performance patterns, style, and active vs. passive.

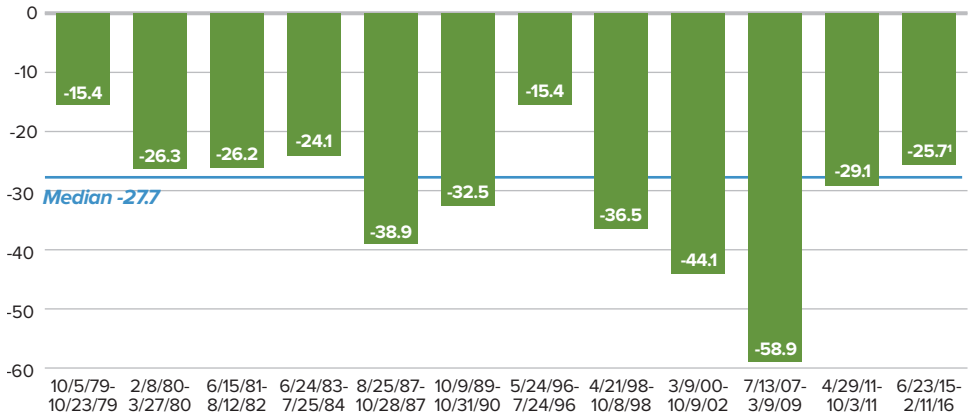
1

Small Caps Had a Stealth Bear Market

While it escaped the notice of many market observers, small-caps experienced a bear market from 6/23/15-2/11/16.

Many investors are unaware that the Small Cap current up cycle is relatively new.

Small-Cap Down Markets
Declines of 15% or Greater Since Russell 2000 Inception (%)



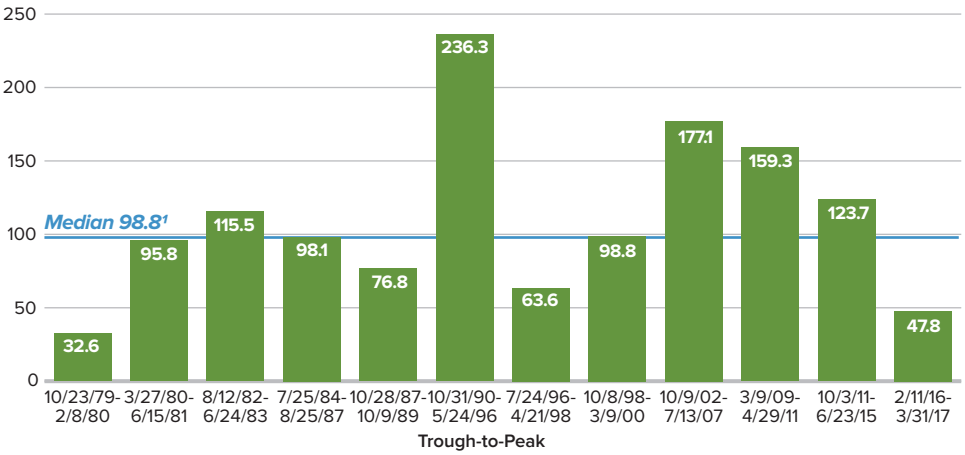
2

Can the Small-Cap Rally Continue?

We think so. The median return for the subsequent recovery period from small cap bear markets was **98.8%**.

The current period saw a recovery of **47.8%** through 3/31/17.

Small-Cap Up Market Performance
After a Decline of 15% or Greater Since Russell 2000 Inception (%)



1 Median includes only full recovery periods

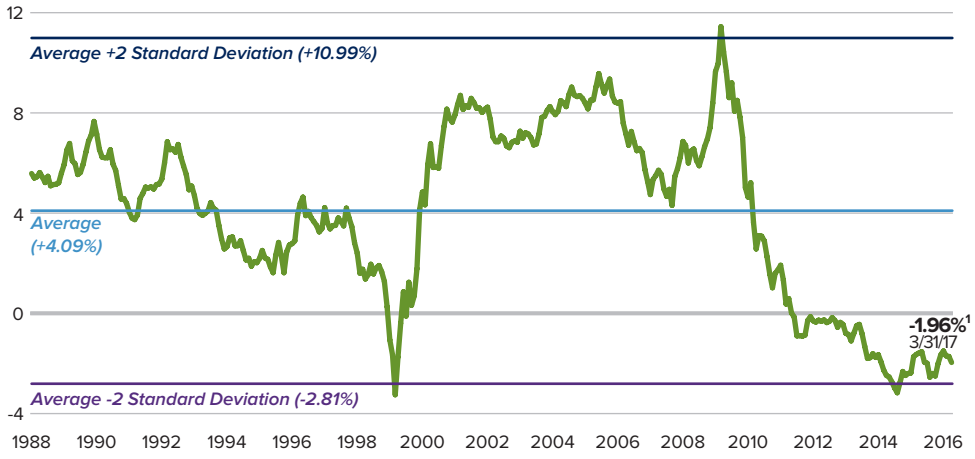
3

Can Value's Outperformance Continue?

The long-term relative performance history of the style indexes suggests that it can.

Despite a strong 2016, Value's trailing 10-year relative return is still significantly below its historical average.

Russell 2000 Value vs Growth Annualized Trailing 10-Year Relative Return Spread as of 3/31/17



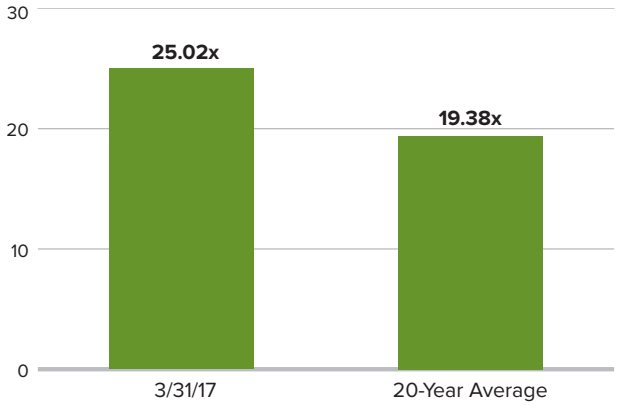
[1]The 10-year average annual total return through 3/31/17 was 6.09% for the Russell 2000 Value and 8.06% for the Russell 2000 Growth. -1.96% represents the difference. **Standard Deviation** is a measure that quantifies the amount of variation or dispersion in a data set. Roughly 68% of the data values are within one standard deviation of the mean.

4

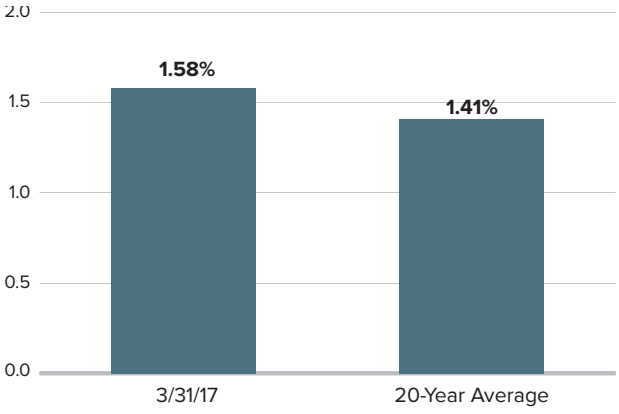
Two Perspectives on Small-Cap Market Valuation

While small-caps look expensive on an absolute valuation, they appear more attractive when taking low bond yields into account.

Absolute Valuation vs. History
Russell 2000 EV/EBIT through 3/31/17



Small-Cap Equity Risk Premium
Russell 2000 Cap Rate (EBIT/EV) Minus 10-Year Treasury Yield through 3/31/17



PE > long-term average
Suggests small caps are fully valued

Equity Risk Premium > long-term average
Suggests small caps are undervalued

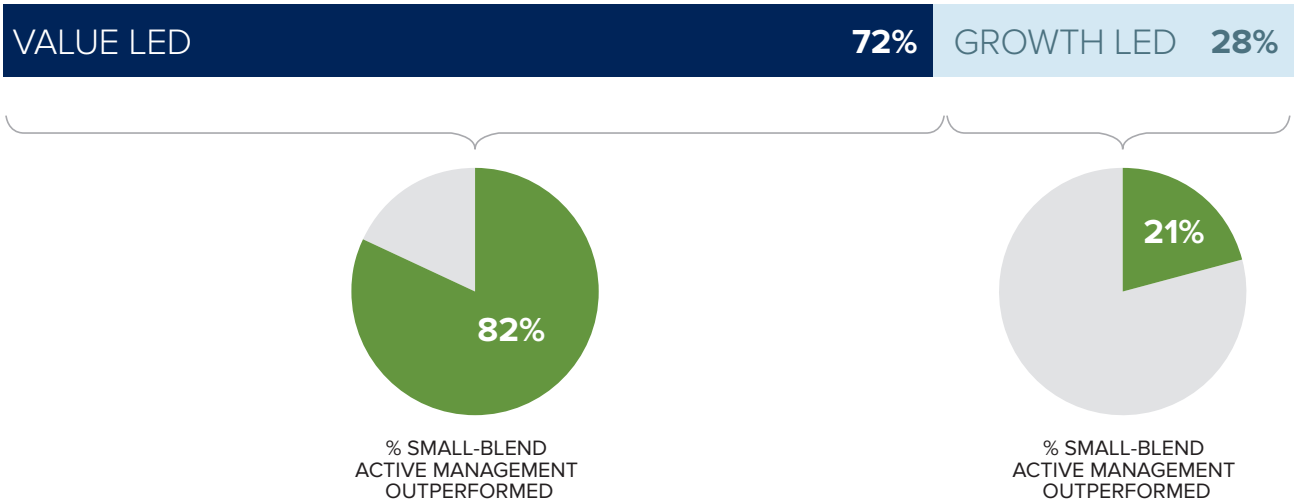
Enterprise Value (EV) is calculated by adding a company's market capitalization, long-term debt, preferred stock, and minority interest, then subtracting cash. **EBIT** is earnings before interest and tax. **EV/EBIT** is a harmonic weighted average. **Cap Rate** is a simple weighted average.

5

Small Blend Active Management Has Outperformed More in Value-Led Markets

There is a discernible historical trend of small-cap active managers beating the Russell 2000 when value stocks lead while trailing the index when growth stocks lead.

5-Year Monthly Rolling Returns from 12/31/78 through 3/31/17 (400 Periods), and % of the Periods Morningstar Small Blend Category[1] Average Beat the Russell 2000



Source: Morningstar

[1]There were 537 U.S. Fund Small Blend Funds tracked by Morningstar with at least five years of performance history as of 3/31/17.

The performance data and trends outlined in this presentation are presented for illustrative purposes only. Past performance is no guarantee of future results. Historical market trends are not necessarily indicative of future market movements.

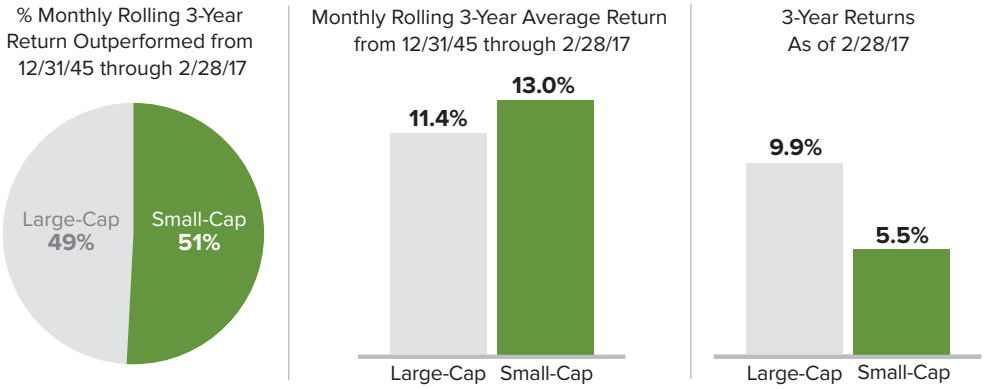
6

Small-Caps Poised for a Rebound?

Based on data going back to the end of WW II, small cap's average 3-year outperformance has been **1.6%**.

However, despite a strong 2016, over the past three years small caps have lagged by **4.4%**.

CRSP 1-5 (Large-cap) and CRSP 6-10 (Small-cap) Performance



Source: CRSP (Center for Research in Security Prices)

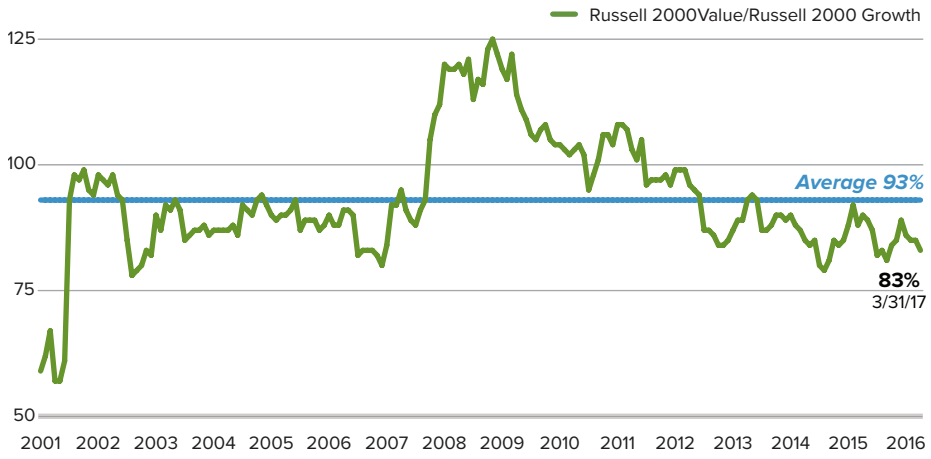
The (Center for Research in Security Prices) CRSP (Center for Research in Security Pricing) equally divides the companies listed on the NYSE into 10 deciles based on market capitalization. Deciles 1-5 represent the largest domestic equity companies and Deciles 6-10 represent the smallest. CRSP then sorts all listed domestic equity companies based on these market cap ranges. By way of comparison, the CRSP 1-5 would have similar capitalization parameters to the S&P 500 and the CRSP 6-10 would have similar capitalization parameters to those of the Russell 2000.

7

Small Value's Valuation Looks Cheap vs. Small Growth

Although overall small-cap valuations are above historical norms, value stocks still look more attractively valued than growth.

Russell 2000 Value and Growth Shifted Median Relative LTM EV/EBIT[1]
Russell 2000 Value/Growth from 12/31/01 to 3/31/17



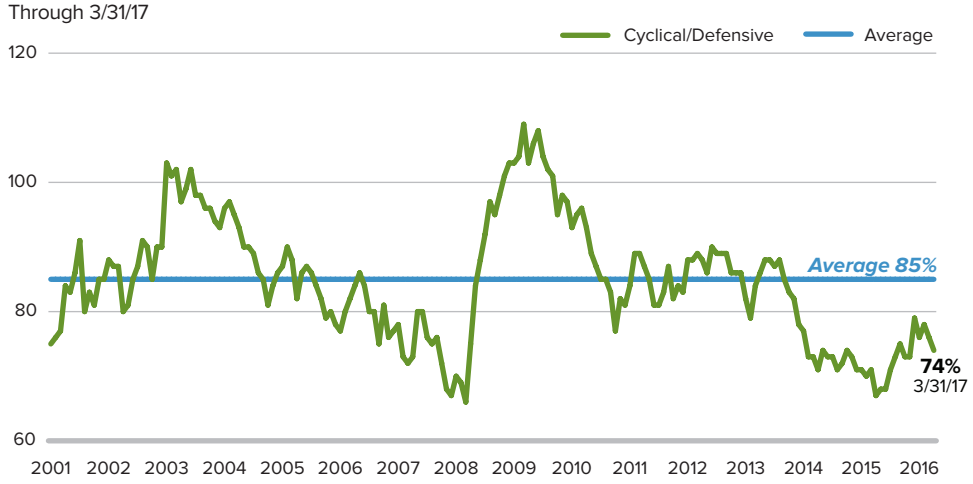
Source: Factset
[1] Last twelve months enterprise value/earnings before interest and taxes.

8

Cyclical Relative Valuation Looks Cheap vs Defensive Sectors

Considering the significant overlap between cyclicals and value stocks, it's not surprising that stocks in cyclical sectors look more attractive than those in defensive sectors.

Cyclical vs. Defensive Stocks Within the Russell 2000 Median Relative LTM EV/EBIT[1] Ex. Negative EBIT
Through 3/31/17



Source: Factset
[1] Last Twelve Months Enterprise Value/Earnings Before Interest and Taxes
Cyclical and Defensive are defined as follows: Cyclical: Consumer Discretionary, Energy, Financials, Industrials, Information Technology, Materials. Defensive: Consumer Staples, Health Care, Real Estate, Telecommunication Services, Utilities

1Q17 Fund Performance and Commentary

It was a positive quarter for the Russell 2000 (+2.5%), but a marginally negative one for the Russell 2000 Value (-0.1%). Our featured value and core portfolios showed a wide range of performance that included two notably impressive results on both an absolute and relative basis.

Value

Royce Opportunity Fund was up 5.2% in 1Q17, beating the Russell 2000 for both the quarter and the one-year period ended 3/31/17 (+33.8% versus +26.2%). The Fund significantly benefited in both periods from its Information Technology holdings.

Royce Total Return Fund advanced 2.2%, though it trailed the benchmark in a quarter when non-dividend payers in the index (+5.6%) handily outperformed dividend payers (0.0%).

Royce Special Equity Fund (-0.3%) gave back a sliver of performance in the quarter after posting the best calendar year return in the Fund's history (+32.2%) in 2016.

For the one-year period ended 3/31/17, Special Equity gained 24.8% while Total Return advanced 22.3%—both strong on an absolute basis, though trailing the index. Known more for downside outperformance, each Funds' underperformance was not surprising in this highly positive period.

Core

Royce Premier Fund, our high-quality core offering, turned in an impressive market-beating performance, up 6.7% in 1Q17. Several high-quality businesses that performed strongly in 2016 continued to execute well and outperform.

Hampered a bit by strong performance for low-quality stocks, **Royce Pennsylvania Mutual Fund** was less stellar, up 1.5% for the quarter. The Fund's multi-discipline approach also includes a meaningful exposure to value stocks, which also trailed.

For the one-year period ended 3/31/17, both funds were behind the small-cap index, with Pennsylvania Mutual up 20.9% and Premier up 25.7% compared to 26.2% for the Russell 2000. Despite strong absolute returns and contributions from numerous industries, relative returns were hindered by underexposure to banks and biotechs, two strongly performing areas.

Performance and Expenses as of 3/31/17

			Average Annual Total Returns (%)							Annual Operating Expenses (%)	
FUND	STYLE[1]	STRATEGY	1Q2017[2]	1-YR	5-YR	10-YR	15-YR	40-YR/ SINCE INCEPT.	INCEPTION DATE	GROSS	NET
Opportunity	VALUE	Deep Value	5.21	33.85	11.98	7.10	9.60	12.40	11/19/96	1.17	1.17
Special Equity	VALUE	Absolute Value	-0.32	24.77	9.46	8.13	9.12	9.39	5/1/98	1.15	1.15
Total Return	VALUE	Dividend Value	2.23	22.33	11.04	6.76	8.48	10.91	12/15/93	1.22	1.22
Pennsylvania Mutual	CORE	Multi-Discipline	1.54	20.90	9.32	6.25	8.60	13.21	N/A	0.93	0.93
Premier	CORE	High Quality	6.71	25.71	8.37	7.85	10.13	11.65	12/31/91	1.13	1.13
Russell 2000			2.47	26.22	12.35	7.12	8.38	N/A	N/A	N/A	N/A

1 Royce classifies a Fund as 'Value' because it anticipates the portfolio will have a weighted average price-to-book ratio lower than the Fund's benchmark or as 'Core' because it anticipates the portfolio will have a weighted average price-to-book ratio that is similar to, or somewhat higher than, the Fund's benchmark. **2** Not Annualized.

Important Performance and Expense Information

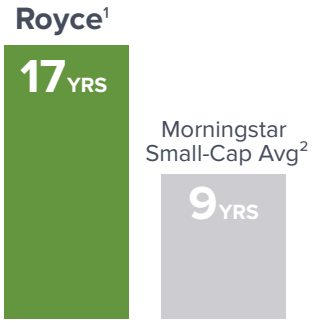
All performance information reflects past performance, is presented on a total return basis, reflects the reinvestment of distributions, and does not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, so that shares may be worth more or less than their original cost when redeemed. Investment and Service Class shares redeemed within 30 days of purchase may be subject to a 1% redemption fee payable to the Fund. Redemption fees are not reflected in the performance shown above; if such fees were reflected, performance would be lower. Current month-end performance may be higher or lower than performance quoted and may be obtained at www.roycefunds.com. All performance and expense information reflect results of the Fund's Investment Class shares. Gross operating expenses reflect each Fund's gross total annual operating expenses and include management fees, any 12b-1 distribution and service fees, other expenses, and any applicable acquired fund fees and expenses. Net operating expenses reflect contractual fee waivers and/or expense reimbursements exclusive of any applicable acquired fund fees and expenses. All expense information is reported as of the Fund's prospectus dated 5/1/16. Acquired fund fees and expenses reflect the estimated amount of the fees and expenses incurred indirectly by any applicable Fund through its investments in mutual funds, hedge funds, private equity funds, and other investment companies.

Service, Consultant, R, and K Class shares bear an annual distribution expense that is not borne by the Fund's Investment Class. The Royce Funds invest primarily in securities of micro-cap, small-cap, and/or mid-cap companies, which may involve considerably more risk than investments in securities of larger-cap companies (see "Primary Risks for Fund Investors" in the respective prospectus). The Funds may also invest to varying degrees in foreign securities which may involve political, economic, currency, and other risks not encountered in U.S. investments. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. The Russell 2000 Index is an index of domestic small-cap stocks that measures the performance of the 2,000 smallest publicly traded U.S. companies in the Russell 3000 Index. Please read the prospectus carefully before investing or sending money. The performance of an index does not represent exactly any particular investment as you cannot invest directly in an index. This material must be accompanied or preceded by a current prospectus. Distributor: Royce Fund Services, LP.

What Makes Royce Distinctive?

Portfolio Manager Tenure

We have a seasoned staff of 16 portfolio managers

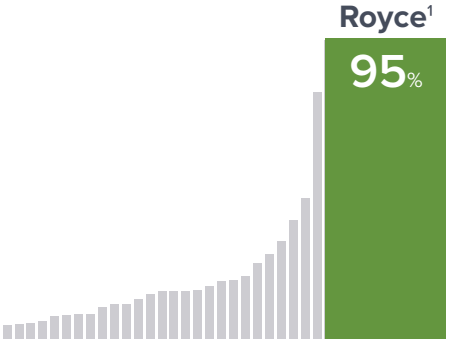


AVG YEARS OF MANAGER TENURE[3]

Small-Cap Specialists

28 firms have >$5B in small-cap fund assets[4]

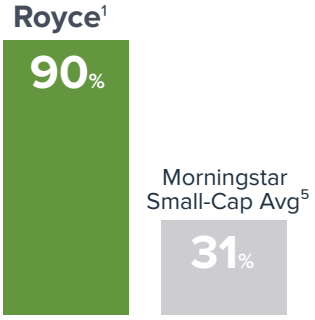
Only Royce has >90% AUM invested in small-cap



% OF TOTAL FUND ASSETS IN SMALL-CAP BY FIRMS WITH >$5B INVESTED IN SMALL-CAP

Significant Portfolio Manager Commitment

Portfolio managers have substantial ownership in the strategies they manage



PERCENTAGE OF FIRM ASSETS WHERE THE MANAGER INVESTS AT LEAST $1M[6]

Source: Morningstar

1 Includes all small-cap open end Royce Funds as categorized by Morningstar (11 Funds as of 3/31/17). **2** Includes all small-cap open-end mutual funds as categorized by Morningstar (594 Funds reported data as of 3/31/17). **3** Reflects the manager with the longest tenure on each fund including time spent as an assistant portfolio manager, co-portfolio manager or portfolio manager. **4** We began with Morningstar data that includes all open-end equity funds domiciled in the U.S. as of 3/31/17. We then narrowed the list to include only those companies with at least one U.S. equity fund. From that group of 588 fund companies, we included only those with a product in at least one of the following categories: U.S. Fund Foreign Small/Mid Blend, U.S. Fund Foreign Small/Mid Growth, U.S. Fund Foreign Small/Mid Value, U.S. Fund Small Blend, U.S. Fund Small Growth, and U.S. Fund Small Value. This resulted in 286 firms with small-cap assets. We narrowed the list again to include only firms with more than $5 billion in small-cap assets, which gave us 28 firms. **5** Includes any fund company with at least one small-cap open-end mutual fund as categorized by Morningstar (247 fund companies reported data as of 3/31/17). **6** The percentage of mutual fund assets with manager investment of more than $1 million shows the portion on an investment adviser's open-end mutual fund assets where at least one fund manager has invested more than $1 million in fund shares, the highest manager-range reported annually to the Securities and Exchange Commission.

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